Testimony of Robert C. Pozen
Hearing on Corporate Governance and Executive Compensation
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I am currently a lecturer at Harvard University, and formerly served as Vice Chairman of Fidelity Investments. But these are my personal views, and do not represent the views of either Harvard or Fidelity.

Thank you for this opportunity to address the general subject of corporate governance. Since this is a broad subject and your Committee will hear other panels on various aspects of corporate governance, I will focus my remarks on practical suggestions in four key areas:

1) Increasing the effectiveness of the audit committee;
2) Requiring shareholder approval of all stock option plans;
3) Enhancing accounting disclosures to buy-side analysts; and
4) Reducing conflicts of interests for sell-side analysts.

l. Increasing the Effectiveness of the Audit Committee

The typical audit committee of a large corporation is hard pressed to understand and monitor the auditing of the company's financial statements. These are detailed documents involving complex transactions and often foreign operations. Moreover, most auditors view themselves as working primarily for the company's executives rather than for the members of the audit committee. Indeed, many members of the audit committee were probably not directors at the time the auditors were first appointed by the company.

Nor would a self-regulatory organization (SRO) for auditing, patterned after the NASD, have much chance of effectively policing the audit process. The NASD is successful because it concentrates on one line of business in one country – e.g., the U.S. broker-dealer subsidiary of Citigroup. But an inspector for an auditing SRO would have little chance of understanding the complex auditing issues and many transactions of large global companies. It would be particularly difficult for such an inspector to find entities that were omitted from the company's financial statements like off-balance sheet partnerships.

By contrast, mandatory rotation of auditors for public companies would create powerful incentives to adhere to both the letter and spirit of the auditing rules. Every five to seven years, the independent audit committee would choose a new auditor based on a public request for proposals with detailed terms and conditions. The incoming firm would have the time, resources and liability risk to comprehend the critical issues in prior audits. More importantly, the current auditor would know that the incoming firm would subsequently scrutinize its auditing decisions.

Mandatory rotation of auditors would have two other salutary effects. First, the auditors would be more accountable to the audit committee than company management because committee members would interview firms and set the terms of the engagement. Second, the rotation process would provide incentives to create new auditing firms – which we desperately need – because new firms would have many opportunities each year to bid for new audit assignments.

Mandatory rotation could increase modestly the costs of audits. However, these incremental costs could be minimized by a competitive bidding process, together with a requirement that the outgoing firm transfer all of its work papers to the incoming firm. Nevertheless, if higher audit fees became a substantial problem for smaller public companies, the SEC should be given the authority to exempt them from mandatory rotation of auditors.

2. Requiring Shareholder Approval of All Stock Option Plans

Whether stock option plans are good or bad for Corporate America depends heavily on the design of such plans. For example, a well-designed plan should impose a minimum holding period before stock options are exercised, and should link the exercise price to above-average performance of the company's stock. To assure that stock option plans do align the interests of the company's executives with the interests of its shareholders, Congress should require that all stock options plans be approved in advance by shareholders of public companies.

Historically, shareholder approval of most stock option plans was built into the federal securities laws, rather than the federal tax laws (with the exception of performance options). However, several years ago, the SEC simplified its exemption for the exercise of stock options from the prohibitions against short-swing trading in Section 16 of the Securities Exchange Act (requiring company executives to disgorge any profits from purchasing and selling company stock within six months). In the process, the SEC inadvertently eliminated the long-standing condition that shareholders approve any stock option plan qualifying for this much utilized exemption.

Since then, shareholder approval of stock option plans has been mandated mainly in the circumstances set by the listing standards for companies listed for trading on the New York Stock Exchange (NYSE). For example, the NYSE does not require shareholder approval of a stock option plan if 50% or more of its shares are to be awarded to employees other than senior executives and directors. During the last few weeks, however, the NYSE has announced its intention to propose a broader requirement for shareholder approval of any stock option plan where options may be awarded to any senior executive.

In my view, it is unfair to ask the NYSE to undermine its competitive position as a trading market by adopting stricter rules than NASDAQ on shareholder approval of stock option plans. It is also unlikely that NASDAQ and the regional exchanges will voluntarily adopt the same rules on stock option plans as the NYSE, given the competition among these markets. More realistically, the SEC should effectively require all publicly held companies to obtain shareholder approval of all stock option plans – by reinstating this requirement as a condition to its exemptive rules under Section 16 for the exercise of stock options.

In addition, the SEC's exemptive rules should provide shareholders with the opportunity to vote on fundamental changes to an existing stock option plan. Many stock option plans allow the company's directors to change fundamental elements of a plan after it has been approved by its shareholders. Although directors need some flexibility in implementing stock option plans, they should not unilaterally change fundamental elements of plan design that were probably important in winning shareholder approval of the plan. Such fundamental elements would include, for example, a restriction on decreasing the exercise price of fixed price options if the company's stock price drops. If there are reasonable justifications for such fundamental changes, they should be put before shareholders to ensure that the design of the stock option plan is still appropriate.

3. Enhancing the Accounting Disclosures to Buy-Side Analysts

Buy-side analysts generate proprietary research on securities for the benefit of the mutual funds and pension funds that employ these analysts. Therefore, buy-side analysts have every incentive to figure out whether a stock is over-valued and, if so, to recommend that the mutual fund or pension fund sell the stock. Unfortunately, the efforts of buy-side analysts are hampered by the quality of accounting disclosures by U.S. companies and the uncertainties raised by SEC Regulation FD (Fair Disclosure).

The SEC has announced that it will propose more extensive disclosure of significant accounting policies in the Management, Discussion and Analysis (MD&A) section of a company's annual report. From the analyst's perspective, the most useful disclosures would show the differential impact of management decisions about key accounting issues reflected in the company's financial statements. These decisions sometimes involve judgment calls between two alternative accounting methods – both of which may be acceptable. For example, analysts would like to see the impact on a company's balance sheet of omitting special purpose entities established by the company, and the impact on the company's income statement of applying management's criteria for recognizing revenue from product sales.

In addition, if a company chooses to publish pro forma earnings, it should at the same time publish a reconciliation of these pro forma earnings with its financial statements under GAAP. Companies can sometimes be quite selective in calculating pro forma earnings – e.g., omitting losses generated from special transactions, while including gains from one-time asset sales. If companies are permitted to publish pro forma earnings, they should be required simultaneously to promulgate a side-by-side comparison explaining precisely which items are being treated differently from GAAP in calculating their pro forma earnings.

More generally, the SEC's Regulation FD is serving as a barrier to intensive analysis of complex accounting issues in company financial statements. Regulation FD has a laudable objective – to prevent senior company executives from disseminating market-moving information selectively to certain investors or friends. But Regulation FD is too vague; its prohibitions are couched in terms of "material" information without a definition of this term. As a result, some senior executives make analyst presentations that are heavily scripted by company lawyers, and refuse to answer legitimate accounting questions posed by analysts in follow-up calls.

The SEC could resolve this dilemma by announcing that, for purposes of Regulation FD, "material" information would include only information that the average retail investor would consider important to a company's stock price – for instance, changes in earnings estimates, announcements of acquisitions or retirement of senior executives. By contrast, "material" information should exclude answers to questions on technical accounting issues that would be important only to an analyst who had become an expert on the company's financial statements. By announcing such an exclusion to Regulation

FD, the SEC would be encouraging analysts to become such accounting experts that they can build a "mosaic" of information on company financial statements – without allowing company executives to selectively disclose information that all investors would consider to be important.

4. Reducing the Conflicts of Interest for Sell-Side Analysts

Since 1995, the mutual fund industry has lived with a tough Code of Ethics on potential conflicts of interest. The Code's standard provisions require not only reporting of all personal trades but also pre-approval of most personal trades and effective bans on certain types of transactions by investment analysts and portfolio managers. Until recently, this type of strict Code has not been regularly applied to analysts in Wall Street brokerage firms (sell-side analysts). But now the NASD has proposed a set of rules that will take important steps toward constraining the conflicts of interest faced by some sell-side analysts.

First, sell-side analysts will be required to disclose their personal ownership positions in the securities recommended by them to investors. Sell-side analysts will not be allowed to trade in such a security for a period of 30 days before and 5 days after the release of a research report or the change in a research rating. A sell-side analyst will also not be allowed to trade in his or her personal account against his or her public recommendation on a security.

Second, any research report will be required to disclose any business relationship between the broker-dealer issuing the report and the company covered by the report. For example, the research report would have to disclose that the broker-dealer recommending a security was also the underwriter of the security in the IPO. More broadly, the research report must disclose the percentage of buy, hold and sell recommendations issued by the broker-dealer over the past year. This should be informative to investors, since the portion of sell recommendations issued by most Wall Street firms has averaged below 5%.

Third, the NASD proposals would take research analysts outside the supervision and control of the underwriting department. In addition, the NASD would not allow the sell-side analyst to be paid directly on the basis of revenues from underwriting a specific stock. However, the NASD proposals would allow the compensation of the sell-side analyst to include as a significant factor the firm's underwriting revenues, as long as that compensation factor is disclosed in their research reports.

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Thank you again for this opportunity to testify before the Senate Finance Committee on this critical subject of corporate governance. I would be pleased to respond to any questions or comments you might have on my testimony.